

CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 374

May 2, 1974

DEDUCTIBILITY OF INTEREST EXPENSE DIRECTLY RELATED TO INDEBTEDNESS INCURRED IN THE ACQUISITION OF SUBSIDIARIES

Syllabus:

Advice has been requested as to the deductibility of interest expense by a parent company, a California taxpayer, when the indebtedness giving rise to the interest was incurred for the purpose of acquiring nonunitary subsidiaries.

Question:

Is such interest deductible?

Decision:

See discussion.

Discussion:

Resolution of this question requires a consideration of Revenue and Taxation Code Sections 24438, 24425, and 24344.

Section 24438 (Stats. 1971, Ch. 1, in effect December 8, 1971), adopted from Internal Revenue Code § 279, provides a limitation upon the amount of interest which may be deducted upon indebtedness incurred to acquire other corporations. The maximum deduction allowable for such interest is \$5,000,000. This "corporate acquisition indebtedness" is defined as any obligation evidenced by a bond, debenture, note, or certificate or other evidence of indebtedness issued by a corporation after October 9, 1969, which meets all of the four following conditions.

1. The obligation is issued to provide consideration for the acquisition of either:
 - a. stock in another corporation, or
 - b. assets of another corporation pursuant to a plan under which at least two-thirds in value of all the assets (excluding money) used in trades or businesses carried on by such corporation are acquired;
2. The obligation is either:

- a. subordinated to claims of trade creditors of the issuing corporation generally, or
 - b. expressly subordinated to any substantial amount of unsecured indebtedness whether outstanding or subsequently issued;
3. The obligation is either:
- a. convertible directly or indirectly into stock of the issuing corporation, or
 - b. part of an investment unit or other arrangement which includes an option to acquire, directly or indirectly, stock in the issuing corporation; and
4. As of the last day of the issuing corporation's taxable year in which any obligation which meets the first test is issued, either
- a. the ratio of debt to equity of the issuing corporation exceeds two to one, or
 - b. the projected earnings do not exceed three times the annual interest to be paid or incurred.

Therefore, with respect to interest expense paid or incurred on "corporate acquisition indebtedness" incurred after December 31, 1970 (§ 24438j), the problem is resolved by statute except for a maximum amount of \$5,000,000.

This leaves for consideration:

1. The up to \$5,000,000 of interest expense §24438 will allow;
2. Interest on corporate acquisition indebtedness incurred before December 31, 1970;
3. Interest on corporate acquisition indebtedness which does not fall within the confines of § 24438.

Treatment of such interest will be determined under §§ 24425 and 24344.

Section 24425 provides:

[No deduction shall be allowed for . . .] Any amount otherwise allowable as a deduction which is allocable to one or more classes of income not included in the measure of the tax imposed by this part, regardless of whether such income was received or accrued during the income year.

In Great Western Financial Corporation v. Franchise Tax Board, 4 Cal.3d 1 (1971), the court was faced with the question of whether expenses (including interest) which the taxpayer had incurred incident to receiving dividends which had been properly deducted from gross income pursuant to section 24402 were deductible. The court held that section 24425 denied the deduction in this case. However, the court did more. It held:

Section 24425 is operative whenever income is eliminated from the measure of the tax under any authority or for any purpose; it states with incontestable clarity that items are nondeductible when allocable to income "not included in the measure of the tax." The dividends in question were not included in income used to measure plaintiff's tax. It follows that the expense items are nondeductible. 3 Cal.3d 1, 6. (Emphasis added.)

In the situation here considered, a parent company has incurred interest expense in connection with its acquisition of a nonunitary subsidiary. Any return from that investment must come by way of dividends. If the parent is commercially domiciled outside California, those dividends will not be included in the measure of its California tax. Southern Pacific Co. v. McColgan, 68 Cal.App.2d 48 (1945); Revenue and Taxation Code Section 25126. Such dividends, then, are from a class of income not included in the measure of the tax. Cal. Admin. Code, Tit. 18, Reg. 24425. It follows that interest expense allocable to that class of income may not be deducted by reason of the prohibition contained in § 24425. This is true even if no dividends are declared in any given year. Section 24425 prohibits the deduction ". . . regardless of whether such income was received or accrued during the income year."

Section 24344 states:

(a) Except as limited by subsection (b), there shall be allowed as a deduction all interest paid or accrued during the income year on indebtedness of the taxpayer.

(b) If income of the taxpayer is determined by the allocation formula contained in section 25101, the interest deductible shall be an amount equal to interest income subject to allocation by formula, plus the amount, if any, by which the balance of interest expense exceeds interest and dividend income (except dividends deductible under the provisions of section 24402) not subject to allocation by formula. Interest expense not included in the preceding sentence shall be directly offset against interest and dividend income (except dividends deductible under the provisions of section 24402) not subject to allocation by formula.

The quoted section of course is the specific statutory authority allowing the deduction of interest and, even more specifically, subdivision (b) thereof deals with the allowability of the interest deduction for unitary businesses.

It is established law that specific terms prevail over the general in the same or another statute which otherwise might be controlling. MacEvoy v. United States, 322 U.S. 102 (1944); Board of Supervisors v. Simpson, 36 Cal.2d 671 (1951); Cal. Civ. Code§ 3524; Cal. Code Civ. Proc. § 1859.

Thus, in view of the broad language quoted above from the Great Western decision and the well-established rule of construction that the specific statute controls the general, a question appears as to which section, 24425 or 24344, should control the instant situation. In Pacific Telephone and Telegraph Co. v. Franchise Tax Board, 7 Cal.3d 544 (1972), the California Supreme Court considered the question of the proper use of Section 24344(b) to reduce the interest expense of a unitary business when that business received deductible dividends from affiliated corporations. As an alternative argument, the Franchise Tax Board advanced the position that under the Great Western decision, section 24425 could be invoked to disallow the interest expense associated with the dividends. By way of a footnote, the court commented upon this proposition as follows:

It has been suggested that the possible loophole would be closed in any event by section 24425 which disallows deductions allocable to one or more classes of income not included in the measure of the tax. (Cf. Great Western Financial Corp. v. Franchise Tax Bd., 4 Cal.3d 1, 5-6 [92 I.Rptr. 489, 479 P.2d 993].) However, subsection (b) deals specifically with the allowability of the interest deduction of corporations which allocate by formula; whereas section 24425 deals with the allowability of deductions generally. Thus, if, contrary to the views expressed herein, subsection (b) were construed as prohibiting the reduction of the interest expense deduction by nontaxable dividends, this construction of subsection (b) might prevail over section 24425. 7 Cal.3d 544, 544, fn. 7.

Since, in making this comment, the court noted the Great Western case, it is clear that the question of the controlling authority was considered; and while the footnote is not a direct ruling on the point, it does not strongly suggest that section 24344 does control.

It is therefore concluded that the provisions of section 24344 will first be applied to that interest not disallowed by section 24438. Thereafter, section 24425 will be applied to disallow interest expense which is allocable to any class of income not included in the measure of the tax.

Application of these rules is set forth in the attached examples.

EXAMPLE I

(Applicable after December 31, 1970)

Business income before interest adjustments			
			(\$ 77,000,000)

Add:

Interest disallowed under 24438:

Total acquisition interest	\$150,000,000		
Allowable acquisition interest	<u>5,000,000</u>	145,000,000	

Interest disallowed under 24344(b):

Total interest expense	\$200,000,000	
Less: Acquisition interest	<u>150,000,000</u>	
Balance	50,000,000	
Less: Business interest income	<u>20,000,000</u>	
Balance (A)	30,000,000	

Total interest income	\$40,000,000
Less: Business interest income	<u>20,000,000</u>
	\$20,000,000

Dividend income	<u>15,000,000</u>	
Balance (B)		<u>\$35,000,000</u>

Interest offset (lesser of balance (A) or balance (B))		30,000,000
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Interest disallowed under 24425:

Total interest expense	\$200,000,000		
Less: Disallowed under 24438	\$145,000,000		
Disallowed under 24344(b)	<u>30,000,000</u>	<u>175,000,000</u>	
Balance		\$ 25,000,000	
Less: Apportionable interest expense	<u>20,000,000</u>	<u>5,000,000</u>	

Business income after interest adjustments		<u>\$103,000,000</u>
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EXAMPLE II

(Applicable before January 1, 1971)

Net income	\$35,000,000
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Less:

Nonbusiness dividend income	\$10,000,000	
Nonbusiness interest income	<u>12,000,000</u>	<u>22,000,000</u>
Business income before interest expense adjustment		\$13,000,000
Add:		
<u>Interest disallowed by 24344(b):</u>		
Total interest expense	\$45,000,000	
Less: Business interest income	<u>6,000,000</u>	
Balance (A)	<u>\$39,000,000</u>	
Interest income	\$18,000,000	
Less: Business interest income	<u>6,000,000</u>	\$12,000,000
Dividends	\$25,000,000	
Less: Eliminated under 25106	<u>15,000,000</u>	<u>10,000,000</u>
Balance (B)	<u>\$22,000,000</u>	
Interest offset (lesser of balance (A) or balance (B))		22,000,000
<u>Interest disallowed by 24425:</u>		
Remaining interest expense	<u>\$17,000,000</u>	
Interest expense determined to be attributable to acquisition of nonunitary subsidiary *		<u>12,000,000</u>
		<u>\$47,000,000</u>

* Disallowance cannot exceed remaining interest expense